AN INTRODUCTION TO ISLAMIC FINANCE AND THE MALAYSIAN EXPERIENCE

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1. Introduction

Islamic financing is a burgeoning area in the field of banking and finance. Its growth has gained significant impetus in recent years with the strength of economies in the Gulf Cooperation Council (GCC) States and in South East Asia. Although, the current global financial crises will have an impact on the Islamic financial sector, it is perceived by proponents of Islamic finance that the Islamic financing sector may gain strength as a result of the fall-out faced by the conventional financial sector. The market for Islamic financing is not confined to the Islamic world and although its reach is not currently as broad as the conventional financing market, it is becoming a viable and in some instances a preferred option, particularly in Asia and the Middle East.

Thirty years ago, Islamic financing was almost unheard of, even in South East Asia where a large proportion of the global Muslim population resides. Malaysia was one of the first countries in the region to introduce a framework and parallel regulatory system for Islamic finance. Today, Islamic financing in Malaysia is a real alternative to conventional financing, with eleven locally owned fully-fledged Islamic banks in the country as well as six foreign owned Islamic banks.

Malaysia has spearheaded itself as an Islamic Financial hub in the region with the establishment of the Malaysia International Islamic Financial Centre (MIFC) initiative. The MIFC is an initiative aimed at promoting Malaysia as a key global player in Islamic finance. To this end, Malaysia has introduced a sound regulatory framework for Islamic financing as well as tax laws which not only seek to ensure that Islamic financial transactions are taxed on an equal footing with conventional financing transactions, but go further to provide tax incentives to the Islamic financial sector to promote the growth of this sector. Recently, other countries, including Indonesia, Hong Kong and Singapore have initiated changes in their tax laws with a view towards taxing Islamic financing transactions on an equal footing as their conventional counterparts, as well as to grant incentives for this financial sector. Indeed, Singapore is pointedly taking steps to become an Islamic finance hub. To some extent, Malaysia has an edge as a Muslim country and secondly, Malaysia has more than a twenty-year lead over Singapore. However, Singapore is a more established financial centre (as indeed is Hong Kong), and will undoubtedly continue to take steps to realise its goal of becoming an Islamic financial hub.

Before discussing the tax issues affecting Islamic financial transactions and the Malaysian tax incentives, it would be helpful to have an understanding of the nature of Islamic finance and its underlying principles.

2. What is Islamic finance?

Islamic finance is based on principles from *Shariah* laws[1] which are fundamental to the Islamic religion. The key factors that differentiate Islamic financing from conventional financing transactions are these:

- the earning/charging of interest is prohibited in Islam
- Islamic financing works on the principle of sharing of profits and losses, and the underlying risks.

While there are numerous types of Islamic financing transactions which have increased in complexity and sophistication over the years, the fundamental concepts behind the majority of Islamic transactions are as set out below:

Wadiah	***Mudharabah***	***Musyarakah***
Under the Wadiah principle, the banks accept deposits from customers (which would include current accounts as well as savings accounts) whereby the funds are kept by the bank on an interest free basis and the banks guarantee to return the funds when required by the customer. Profits made by the bank from the utilisation of the funds will be shared, the portion of which will be at the bank's discretion.	*This is a profit-sharing arrangement made between two parties i.e. the bank and the borrower. The concept allows the use of the funds for the borrower's business purposes, with profits being shared between the parties on pre-arranged terms. Losses will be borne by the bank, unless these arise through the willful default or negligence of the borrower, etc.*	*This is a joint venture arrangement between the bank and the borrower to undertake a specific business venture. The profits will be shared according to a pre-agreed ratio, and losses, if any, will also be borne based on agreed terms.*

Ijarah	***Istisna'***
This refers to a leasing arrangement where the bank purchases the asset and leases the asset to the lessee at agreed lease rentals/profit	*This refers to a sale and purchase agreement whereby the bank acquires the asset and sells this to the borrower on a deferred sale basis. The borrower pays for the assets in installments which would cover the bank's cost as well as a profit element.*

[1] *Shariah* laws are laws based on Islamic principles of jurisprudence

The underlying principle behind Islamic financing transactions is that any predetermined fixed amount or charge earned merely from the using or holding of funds belonging to another is strictly prohibited. To put it simply, interest is strictly prohibited. Instead, Islamic financing transactions are based on the derivation of profit, some of which may be pre-determined but the final amount being dependent on the success (or otherwise) of the business venture undertaken. Accordingly, Islamic transactions often involve additional steps as compared with conventional financing transactions to facilitate the notion of the parties being involved in a business venture, rather than a lending transaction per se. Typically, such transactions would involve underlying economic activities and/or assets.

In large capital or fund raising exercises which would involve the issuance of bonds in conventional financing, the equivalent in Islamic capital raising exercises involves the issuance of ***Sukuk.*** *Shariah* law prohibits the trading or sale of debts per se, and instead requires that all financing transactions involve specific assets. A *sukuk* transaction would therefore typically involve an underlying asset to be purchased or constructed, and the returns would be based on performance of the underlying asset. Therefore, *sukuk* are essentially Islamic bonds which provide investors with a share of the underlying asset and the accompanying upside or risk attached to the asset, without the concept of interest.

Therefore, instead of earning interest, investors earn a share of income derived from assets, e.g. rental from property or income from commercial debt obligations and transactions. The Malaysian *sukuk* market has grown significantly and Malaysia is the main issuer within the global *sukuk* market. Malaysia's share of the global *sukuk* market as at the end of 2008 was approximately 57%.[2] Malaysia's share may shrink slightly with the GCC's planned *sukuk* issuance poised to grow, although this would clearly be subject to the significant economic contraction being faced by several GCC states currently. Typically, *sukuk* are perceived to be less risky that conventional bonds, and indeed in many instances have been known to perform better in terms of returns than conventional bonds.

It is important therefore to understand the mechanics of a *sukuk* issuance and the relevant income streams. *Sukuk* are typically issued based on the principles of Islamic finance outlined above. The following sets out a brief description of some of the common types of *sukuk* structures (used in Malaysia)[3]:

- *Sukuk* based on the *ijarah* concept (which is akin to lease financing) – this type of *sukuk* issuance would generally be used in funding the acquisition of property, such as real property, machinery and equipment, etc. This would involve the setting up of a Special Purpose Vehicle (SPV) which would acquire the asset. The acquisition of the asset will be funded by the issuance of *sukuk* to investors. Thereafter, the SPV will lease the asset back to the lessee, who is essentially the party seeking financing. The investors will have

[2] Source: Bank Negara Malaysia (i.e the Central Bank)
[3] Reference: http://www.mifc.com

a share of the property in question and will derive their returns in the form of 'profits' from the asset. This may be fixed or may be variable. As the profits will be based on asset ownership, this is generally acceptable under *Shariah* principles. At the end of the lease term, the lessee may be entitled to buy the asset at pre-agreed terms. Therefore, from the borrower's perspective, rather than issuing a bond to raise funds to acquire an asset, the borrower leases the asset from the SPV which in turns issues the *sukuk*, giving the investors rights over the asset in question, and deriving a profit therefrom, rather than merely lending and deriving interest income, without any 'ownership' in the asset.

- *Sukuk* based on the *musyarakah* principle (i.e. a joint venture, sharing in profits and losses) – this type of *sukuk* is mainly used to finance large-scale projects, e.g. a large construction or development project, and would typically involve the following:

  The entity seeking to develop the land ('the developer') will enter into a *musyarakah* arrangement (i.e. a joint venture) with an SPV. The joint venture will entail the developer contributing the asset, i.e. the land in this instance, and the SPV contributing the funds. The SPV will fund the project for a fixed period in return for an agreed profit share based on a pre-determined profit sharing ratio. The developer will be appointed as the agent to undertake the project and develop the land and to sell or lease the developed assets on behalf of the joint venture. The SPV raises the funds to purchase the asset via the issuance of *sukuk*, and the *sukuk* investors will get a share of the profits from the sale/lease of the developed assets. The developer will undertake to buy the *musyarakah* shares (i.e. increase its stake in the joint venture) in the SPV on a periodic basis (which is essentially the method of repaying the SPV for the financing). At the end of the arrangement, the developer will have acquired the musyarakah shares and the SPV will no longer have shares in the musyarakah arrangement.

The above merely provides simple examples of how some *sukuk* arrangements are structured. It should be noted that as the *sukuk* market has grown and evolved, *sukuk* structures have also grown in complexity. Nonetheless, s*ukuk* issuances are becoming more commonplace in Asian and Middle Eastern capital markets and are increasingly seen as an attractive alternative to conventional bonds in raising capital. However, it is also pertinent to note that the Accounting and Auditing Association for Islamic Financial Institutions (AAOIFI) has recently expressed concerns over the nature of some *sukuk,* taking the view that many of these are not strictly *Syariah* compliant. If this were to lead to a tightening of the rules to ensure more rigorous adherence to *Syariah* principles, this would clearly affect the *sukuk* market as a whole.

3. The Malaysian Experience

Having considered the basic principles underlying Islamic financial transactions and the general growth trend of Islamic finance, particularly in Asia, the rest of this article will

focus on the Malaysian experience, and in particular, the tax measures adopted in Malaysia to spur the growth of the Islamic Financial Sector and to make Malaysia an Islamic Finance hub. To this end, as mentioned above, Malaysia established the MIFC in 2006. The MIFC is an initiative involving the Central Bank of Malaysia, the Securities Commission of Malaysia, the Labuan[4] Offshore Financial Services Authority and Bursa Malaysia (the Kuala Lumpur Stock Exchange) working in collaboration with the banking, *takaful*[5], and capital market industry players. The following are the focus areas of the MIFC:

- *Sukuk* origination
- Islamic fund and wealth management
- International Islamic banking
- International Takaful
- Human Capital Development

Tax incentives are clearly an important aspect in developing and promoting the Islamic financial sector. However, prior to the introduction of tax incentives for Islamic finance, Malaysia took fundamental steps to ensure that Islamic financial transactions were not taxed differently from conventional financing transactions, notwithstanding the inherent differences between the two. As has been highlighted above, interest is strictly prohibited under Syariah principles and hence is not a feature of Islamic financial transactions. Instead, Islamic financial transactions operate on the basis of 'profit' earnings. Therefore, as a first step in initiating the convergence in the tax treatment of Islamic and conventional financing transactions, the Income Tax Act, 1967 (ITA) was adapted to define 'interest' as follows:

"Any reference in this Act to interest shall apply, mutatis mutandis, to gains or profits received and expenses incurred, in lieu of interest, in transactions conducted in accordance with the principles of Syariah."[6]

Effectively therefore, the profits derived from Islamic financial transactions will be treated as interest for tax purposes, and on the flip side, the payment of profits by the borrower will be treated as interest costs from a tax perspective. This would mean that such costs would be subject to the interest restriction rules applicable in Malaysia[7] as well as thin capitalisation rules.[8]

Secondly, the ITA recognises the reality that many Islamic financing transactions require an interest in an underlying asset and hence may involve asset transfers, i.e. additional

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[4] Labuan is an international business and financial centre. It is an island within Malaysia, but operates a separate and distinct corporate as well as tax framework. Labuan offshore companies carrying out offshore business activities as defined in the Labuan Offshore Business Activity Taxes Act1, 1990 are taxed at 3% on net profits or can elect to pay RM20,000 instead. Generally, this preferential tax rate is not permitted where Labuan offshore companies deal with other Malaysian residents.

[5] Takaful is an Islamic insurance concept.

[6] Section 2(7), ITA

[7] Section 33(1) & Section 33(2), ITA

[8] Introduced with effect from 1 January 2009 pursuant to Section 140A(4), ITA

steps may be required in implementing an Islamic financing transaction than those required in a conventional financing transaction. Therefore, the ITA also provides as follows:

"Subject to subsection (7), any reference in this Act to the disposal of an asset or a lease shall exclude any disposal of an asset or lease by or to a person pursuant to a scheme of financing approved by the Central Bank, the Securities Commission or the Labuan Offshore Financial Services Authority, as a scheme which is in accordance with the principles of Syariah where such disposal is strictly required for the purpose of complying with those principles but which will not be required in any other schemes of financing."[9]

The above ensures that where assets are required to be transferred (which would not otherwise be necessary under conventional financing schemes), the transferor is not subject to balancing adjustments on the 'disposal' [10], such that the transaction remains tax neutral.

As outlined above, the principles underlying Islamic financing transactions often involve the concept of a joint venture entailing the sharing of profits and/or losses, which could give rise to a 'partnership' from a tax perspective. This too has been addressed in the ITA and the issue of a 'partnership' for tax purposes does not arise as a result of changes in the ITA to the definition of 'partnership'. The definition of 'partnership' specifically excludes the following:

"any association which has been established pursuant to a scheme of financing in accordance with the principles of Syariah"[11].

Additionally, under the ITA, the payment of interest by licensed banks/financial institutions to non-residents are generally exempt from withholding tax. This exemption has been extended to also cover licensed Islamic banks/financial institutions in respect of payments of 'profit'.[12]

The above are the key changes that have aligned the tax treatment for Islamic financial transactions with that of conventional financing transactions. Without the above express provisions in the ITA, Islamic transactions would not be taxed on an equal footing with conventional transactions and could result in additional taxes, which would clearly be detrimental to the development of the Malaysian Islamic financial sector. In addition to changes outlined above in respect of the ITA, changes have also been made with respect to the Stamp Act, 1949 to ensure that Islamic financing transactions are not adversely taxed as compared with conventional financing transactions.

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[9] Section 2(8), ITA

[10] Under Schedule 3 of the ITA, where an asset on which capital allowances have been claimed is disposed off, a balancing allowance or charge will arise to the disposer, based on the difference between the sales proceeds and tax written down value (or residual value) of the asset

[11] Section 2, ITA

[12] Pargraph 33, Schedule 6, ITA

Having ensured the convergence of the tax treatment between Islamic financial transactions and their conventional counterparts, the Government has taken further measures to provide interesting tax incentives for the Islamic finance industry. These measures have been designed alongside the MIFC's five focus areas outlined above to develop Malaysia as a regional Islamic financial hub.

- ***Tax Exemption for Islamic Financial Institutions***

A ten year tax exemption[13] has been given to International Islamic Banks, International *Takaful* Operators or International Currency Business Units (ICBU)[14] on the statutory income[15] arising from Islamic banking/*Takaful* businesses in currencies other than Ringgit and from "qualifying Ringgit accounts" (i.e. an account of investment made in Ringgit which is related and incidental to the business).

The above exemption entails a separation of accounts in respect of Ringgit and non-Ringgit transactions for tax purposes as the exemption only applies to non-Ringgit transactions to encourage Islamic financial institutions to transact internationally in making Malaysia an international Islamic financial hub.

- ***Tax Incentives for the Issuance of Islamic Securities***

Typically, the costs incurred in relation to the raising of finance are not deductible for tax purposes on the basis that such costs are viewed as capital in nature. However, to encourage the use of Islamic securities in fund raising exercises, where a company (borrower) establishes a special purpose company (SPV) to issue Islamic securities, the borrower is entitled to a deduction for the costs incurred by the SPV in issuing the securities.[16] The SPV is basically a 'see through' vehicle in this instance and the 'borrower' is deemed to have incurred the costs for tax purposes.

In addition to the deduction for the costs of issuance of Islamic securities, the following income derived from Islamic securities is also exempt from tax:

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[13] The exemption is given pursuant to the Income Tax (Exemption) (No.12) Order 2007 from the year of assessment 2007 - 2016

[14] An ICBU is:

- An Islamic Bank licensed under the Islamic Banking Act 1983 which carries on Islamic banking businesses in currencies other than Ringgit (i.e. the Malaysian currency)
- A licensed institution under the Banking and Financial Institutions Act 1989 and approved to carry on Islamic banking business in currencies other than Ringgit – this would include an Islamic window of a conventional bank
- A takaful operator registered under the Takaful Act 1984 which carries on a takaful business in currencies other than Ringgit

[15] Statutory income refers to income which has been adjusted for tax purposes and after capital allowance claims.

[16] Income Tax (Deduction on the cost of Issuance of Islamic Securities) Rules 2007

- profits paid to a non-resident company (unless the profit accrues to a place of business in Malaysia of that company) in respect of Islamic securities or debentures issued in Ringgit (other than convertible loan stock) and approved by the SC [17]
- profits paid to any person (both resident and non-resident) on Malaysian originated non-Ringgit Islamic securities.[18]

- ***Tax Exemption for Islamic Fund Management Services***

A ten year tax exemption (starting from the year of assessment 2007 to the year of assessment 2016) is granted to licensed Malaysian resident fund management companies on statutory income arising from the provision of fund management services to foreign and local investors. The funds in this instance must be managed in accordance with *Syariah* principles (as certified by the Securities Commission) to enjoy the exemption.[19]

- ***Tax Deduction for Costs Involved in Establishing an Islamic Stock Broking Firm***

Costs incurred prior to the commencement of a business are generally not deductible for tax purposes as these do not meet the requirement that the costs must be incurred wholly and exclusively in the production of income. Therefore, when costs are incurred prior to the commencement of business, there will not be an income source against which the costs can be deducted. However, to encourage the establishment of Islamic stock broking firms, a tax deduction is allowed for the establishment expenditure incurred, i.e. consultancy and legal fees, costs of feasibility studies, market research, costs of obtaining appropriate licences and business approvals for undertaking an Islamic stock broking business.[20]

- ***Tax Exemption on Income from the Dealing of Non-Ringgit Sukuk***

Certain categories of persons who are tax resident are exempt from tax on statutory income derived from dealing in non-Ringgit *sukuk* that originates from Malaysia (provided the *sukuk* are issued by the Government or are approved by the SC).[21]

Additionally, resident persons who derive fees from advice on corporate finance in relation to arranging, underwriting and distribution of non-Ringgit *sukuk*, are exempt from tax on the statutory income arising therefrom.[22]

- ***Tax Exemption for Non-Resident Islamic Finance Experts***

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[17] Paragraph 33A, Schedule 6, ITA
[18] Paragraph 33B, Schedule 6, ITA
[19] Income Tax (Exemption)(No.15) Order 2007 & Income Tax (Exemption)(No.6) Order 2008
[20] Income Tax (Deduction on Expenditure for Establishment of an Islamic Stock Broking Business) Rules 2007
[21] Income Tax (Exemption) (No.9) Order 2008
[22] Income Tax (Exemption) (No.10) Order 2008

Payments to non-residents for the provision of services in Malaysia attract withholding tax at 10% on the gross payment (unless the Malaysian double tax agreement with the country of residence of the non-resident provides for a lower withholding tax rate).[23] To encourage the build-up of expertise in the Islamic financial sector, non-residents who provide their expertise in Malaysia are exempt from withholding tax. It should be noted however that where such persons are employed in Malaysia, they would be subject to income taxes on their employment income.[24]

- ***Stamp Duty***

Aside from income tax, financial transactions often involve stamp duty costs. To ensure that Islamic transactions are not subject to adverse stamp duty implications, various stamp duty exemption orders have been issued over the years which have the impact of exempting stamp duty on additional instruments necessarily required in Islamic transactions to streamline the stamp duty implications of Islamic financing to that of conventional financing. Additionally, as an incentive to encourage interested parties to use the Islamic financing option and to grow this sector, a 20% stamp duty exemption is given on Islamic financial instruments that have been approved by the Central Bank or by the SC.[25] Further, a 100% stamp duty exemption is available for 10 years in connection with instruments executed by International Currency Islamic Financial Institutions and on instruments relating to Ringgit and foreign currency Islamic securities. These are added incentives to opt for Islamic rather than conventional financing as stamp duty costs associated with large financing transactions can be quite significant.

Conclusion

The above summarises the main Malaysian tax developments in relation to Islamic finance. Clearly, the tax incentives are important and should play an important role in nurturing and encouraging the on-going development and growth of this sector. However, aside from tax incentives, what is arguably more important is the need to ensure a clear regulatory framework for the Islamic financial sector. Equally important is the need to have skilled human talent in this niche market to create innovative and sophisticated Islamic financial instruments that are both marketable and *Syariah* compliant. The MIFC initiatives have certainly gone some way towards to addressing the needs and challenges of developing Malaysia as an international Islamic financial hub and it is expected that the initiatives will continue to evolve with time. However, healthy competition from Singapore, Hong Kong and the GCC countries, as well as the current global financial crisis will undoubtedly have an impact on Malaysia's progress in this sector.

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[23] Section 4A, ITA
[24] Income Tax (Exemption) (No.3) Order 2008
[25] Stamp Duty (Remission)(No.2) Order 2007